

University of Brawijaya

SNAP-SHOT OF INDONESIAN ECONOMIC PERFORMANCE

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1. Introduction

Indonesia was one of countries in Asia which experienced a high economic growth in early 1990's. From 1987 to 1996, growth of Indonesian GDP has reached 7.1% which accounted as the great performance over the decade. This situation was mainly influenced by the financial deregulation in early 1980s which had triggered a great expansion in capital inflow and credit growth. However, the economy continued to overheat and asset price bubbles emerged in early 1990s which also led Indonesian economy susceptible to external shocks.

In 1997, Indonesian economy experienced a huge shock due to a currency crisis which broadened to a banking, financial and general economic crisis. Actually, the origin of the crisis was not mainly caused by the lax of macroeconomic policies, instead the unwell-developed financial system like unsound banking sector. At its heart, the Indonesian crisis was a banking crisis brought on by banks which took too many foreign currency risks.

The recovery process of Indonesian economy has shown a slow pace due to a complexity of the domestic problems from 1997-2000. The political tension, for example, contributed to the uncertainty and led the recovery program did not work properly. This tension was reflected by the weakening of the rupiah, expectations of rising inflation, and decelerating economic activities. It appears that rising uncertainty has contributed to a slow economic recovery in Indonesia, although the momentum for recovery was in place, as indicated by a relatively high level of growth (4.8 percent) in 2000 and good progress in banking reform as well as corporate debt restructuring during the year.

The slow of the recovery process was also caused by mismanagement of economic policy in the event of crisis. In banking sector, for example, the closing of the insolvent banks has led to a run bank and caused the economy fall into a deep recession. Furthermore, a tight monetary policy that was always going to be some part of the response has also led to problems in investment and banking sector due to a high interest rate.

A gradual improvement of the recovery process has started since 2000, reflected in the stable inflation and exchange rate, reduction in the debt-to-GDP ratio and a manageable fiscal deficit in the last 5 years. Furthermore, Growth of GDP as represent of economic performance reached to 4.9% over the 6 years since 2000. In a policy side, fiscal and monetary policies have always shown a reasonably conservative. Inflation rates were low by developing country standards, budgets were reasonably controlled in most cases, and government debt levels were generally not excessive. Furthermore, these achievements also indicate to the strong commitment to sound economic policies.

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However, a stable macroeconomic condition in Indonesia has not been accompanied with robust or quality economic growth because consumption remains the primary driving force in economic growth. This situation has been identified as consequence of supply side rigidities which also make monetary and fiscal policy can not be optimally used to push a higher economic growth. Furthermore, in the banking sector, an underperforming intermediation function continued to overshadow industrial performance. Consequently, economic growth in recent years was not followed by a significant reduction in unemployment and poverty and had little effect on income disparities.

Following on from this introduction, the reminder of this paper is structured as follows. The section two considers the economic performance in Indonesia from 2000-2006. The section three reveals the recent challenges to economic policy. Finally, concluding remarks are provided in the fourth section.

2. Snap-Shot of Economic Performance in Indonesia

2.1. Indonesian Economy performance 2000-2006

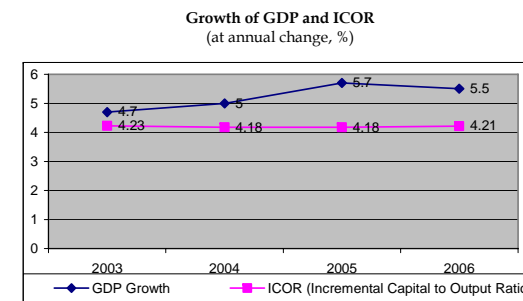
Indonesian economy after the crises shows a slow process of recovery due to a complexity of the domestic problems. Based on the graph below, the years to recover for Indonesia is 7 years, with average annual GDP percentage reached 4.9% from 2000-2006. However, In general, the Indonesian economy has experienced gradual improvement since 2000. The growth of GDP, for example, remained stable around 5% from 2000-2006. In 2006, the growth of GDP was mainly strengthened by the fiscal stimulus and robust export performance that mitigated the impact of weak public purchasing power. Analyzed by sector, the most vigorous growth took place in primary and services sectors. The robust performance of the two sectors in turn helped to promote more rapid recovery in economic activity in 2006.

Table 1
East Asian GDP
Average annual percentage growth

	1987-1996	1997-1999	2000-2006	Years to recover
Hong Kong	5.2	-0.8	4.7	3
Indonesia	7.1	-6.4	4.9	7
Korea	8.1	1.0	4.6	2
Malaysia	9.5	-0.8	4.7	6
Philippines	3.6	1.4	4.6	3
Singapore	9.2	2.8	4.6	2
Taiwan	7.2	5.1	3.3	5
Thailand	9.5	-3.3	5.1	3
East Asia*	7.6	0.0	4.5	-

Sources: IMF, RBA, CEIC

Furthermore, the other macroeconomic indicators are also show a stable movement in the last 6 years, reflected in the stable inflation and exchange rate, reduction in the debt-to-GDP ratio and a manageable fiscal deficit. In spite of the improvement in macroeconomic condition, the investment and exports, the former dominant engines of economic growth, have not a significant improvement since the crisis 1997. This situation is mainly as a consequence of supply-side rigidity which also makes ineffectiveness of fiscal and monetary policies in influencing economic output. A further consequence, economic growth in recent years was not followed by a significant reduction in unemployment and poverty and had little effect on income disparities. The specific aspects of economic performance are covered in more detail below.



Source: Bank Indonesia

Table 2
Poverty and Unemployment rate from 2003-2005
(at annual change, %)

	2003	2004	2005
Poverty	17.4	16.7	16.0
Unemployment rate	9.5	9.41	10.84

2.1.1 Income, Consumption and Investment

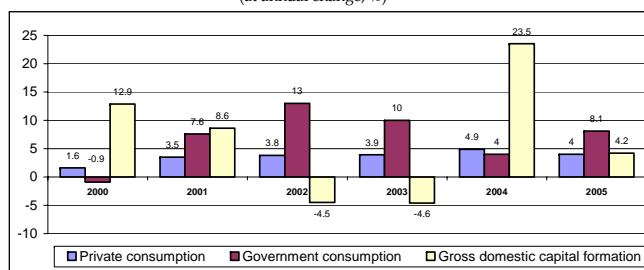
As a structure of GDP, consumption is mainly contributed to the biggest share of GDP. As can be seen from the table below, it accounted 65.4 % of GDP in 2005, increased 3.7% from 2002. Furthermore, the growth of consumption has increased significantly since 2000, reached 4% in 2006. On the other hand, the share domestic capital formation in GDP remained flat at 22% of GDP since 2002. It reached the highest percentage in 2003 at 25.3%, but continued to decrease to 22.2% in 2005. Consequently, this weakened investment performance has continually impacted on the quality of growth which was steady on 5%.

Table 3
Structure of Demand % of GDP
(at current prices)

ITEM	2000	2001	2002	2003	2004	2005
Private consumption	61.7	61.7	66.1	67.4	67.4	65.4
Government consumption	6.5	6.7	7.1	8.0	8.4	8.2
Gross domestic capital formation	22.2	22.0	20.9	25.3	23.2	22.2
Exports of goods and services	41.0	38.2	32.0	30.1	32.1	33.5
Imports of goods and services	30.5	30.1	25.8	22.7	27.4	29.2

Source: Bank Indonesia

Growth of Consumption and Investment
(at annual change, %)



Source: Bank Indonesia

As reported by Bank Indonesia, Total Factor Productivity (TFP) fell to below 1.0% in the 2000-2004 period, far below the 3.0% TFP during the 1993-1997 period. Furthermore, ICOR (Incremental Capital to Output Ratio) also showed a high trend since 2003, showing the bad signs of capital efficiency to growth. These factors combined to produce supply side rigidity, which hampers efforts to pursue more rapid expansion in economic capacity. The combination of an unresponsive supply side and a more consumptive household sector has constricted policy options for pursuing a higher rate of sustainable economic growth. This is because accelerated growth will be followed by stronger upward pressure on prices. As a rule, supply side rigidities increase the economy's vulnerability to shocks and are also responsible for poor quality of growth, persistence of inflation, entrapment of the economy in an excess liquidity spiral and lack of macroeconomic policy effectiveness in promoting growth.

2.1.2 Financial Performance

Banking sector since 2002 has demonstrated relatively sound performance, reflected in Loan to Deposit Ratio (LDR), Return on Capital (ROA) and Capital Adequate Ratio (CAR). Instead, Non Performing Loans (NPL) shows a deterioration performance over the last 2 years due to the restructuring of non-performing corporate loans at two state-owned banks. There were also numerous structural problems in the real sector that paved the way for banking prudential practices in playing their intermediary role, particularly in the disbursement of credit.

Table 4
Commercial Banks Performance Indicators

	2002	2003	2004	2005	2006
LDR (Credit/Deposit)	49.1	53.7	61.8	64.7	64.7
ROA (%)	1.9	2.5	3.5	2.6	2.6
NPL Gross (%)	8.1	8.2	5.8	8.3	7.0
CAR (%)	22.5	19.4	19.4	19.5	20.5

Source: Bank Indonesia

2.1.3 External vulnerability

External balance, otherwise called *balance of payment equilibrium* refers to the ability of the residents of a country to pay their way in international transactions. In general, the balance of payments account is a systematic record of the country's international economic transactions of both current and capital nature, conducted within a defined period time. In general, Indonesia's balance of payments showed better improvement over the last 3 years. As can be seen from the table 6, the percentage of Current Account to GDP reached 2.6 in 2006, increased significantly from 2004 that just reached below 1.

Surplus of balance of payment also represents that the domestic savings exceeds the domestic investment. As can be seen from table 5, the total of government and private savings exceeds the total of government and private investment. Although, the government has ruined a budget deficit over the last 5 years, the gap can be filled by the private savings.

Table 5
Savings-Investment Gap
(2001-2006)

ITEM	2001	2002	2003	2004	2005	2006
Government						
Saving Deposits	1.8	2.6	3.8	3.7	3.0	3.6
Investment	4.2	3.9	5.5	4.7	3.5	4.6
Deficit/Surplus	-2.4	-1.3	-1.7	-1.0	-0.5	-1.0
Private						
Saving Deposits	21.6	20.3	18.9	19.4	20.7	23.0
Investment	15.0	15.1	13.8	17.7	20.1	19.4
Deficit/Surplus	6.6	5.2	5.1	1.6	0.6	3.7
Total						

Saving Deposits	23.4	22.9	22.7	23.1	23.7	26.6
Investment	19.2	19.0	19.3	22.4	23.6	24.0
Deficit/Surplus	4.2	3.9	3.4	0.6	0.1	2.6
Exchange Rate (Rp/\$)	10,256	9,318	8,572	8,940	9,713	9,167

Source: Bank Indonesia

From domestic side, competitiveness of Indonesia's non oil-gas products - especially natural resource based - was still high, while return of rupiah investment in financial markets also became more attractive as risk factors improved. Besides, the flow of foreign direct investment (FDI)-primarily in the oil-gas sector reported an increase in proportion to raising oil price over the last three years. Other economic developments also had an impact on the balance of payments in 2006. Slower domestic demand growth stemmed imports growth. Given that background, Indonesia's balance of payments recorded a surplus of \$15.0 billion in 2006 or 2.6 as represent by percentage of Current Account/ GDP.

Table 6
Indicators of External Vulnerability

ITEM	2004	2005	2006
Current Account/GDP	0.6	0.1	2.6
Exports of Goods and Services/GDP	34.3	37.4	33.3
Debt Service Ratio1)	27.1	17.3	24.5
Foreign Debt/GDP	53.9	45.1	33.9

Note: 1) Debt Service Ratio (DSR) increased in 2006 due to IMF debt repayment of \$7,6 billion
Source: Bank Indonesia

3. Recent Challenges to Economic Policy

Generally, Indonesian economic performance in 2006 shows a better improvement, reflected in some macroeconomic indicators such as exchange rate, GDP and inflation. This improvement has also proof a sound macroeconomic policy in Indonesia, specifically the consistency of central bank of Indonesia to achieve inflation target and macroeconomic stability. Despite this, Indonesian economy is facing a greater challenge in micro structural problems which burden the development of investment and export competitiveness. Furthermore, the problem of banking intermediary is also need to be resolved in order to boost the economic expansion. The specific aspects of recent challenges to economic policy are covered in more detail below.

Table 7
Comparison of Assumption and Realization
Of Inflation Target in 2006

Variable	2006	
	Target	Outcome
Exchange Rate (Rp/\$)	9.472 - 10.156	9.166
GDP	5% - 5.7%	5.5%
Core Inflation	7.2% - 7.5%	6.03%
CPI Inflation	7% - 10%	6.60%

Source: Bank Indonesia

3.1. Investment policy

Investment is one of the important indicators to ensure the quality of economic growth performance. The improvement of investment growth is needed to absorb the excess labor supply and to boost higher welfare. However, the investment performance in Indonesia has not shown a significant improvement after the crisis. Regarding to this problem, the issue of enhancing better quality growth is the key success. Thus, government needs to be more serious to implement various policies for improvement of the investment climate with the support of stable macroeconomic conditions.

The weak investment climates, poor quality of infrastructure and problems with bureaucratic inefficiency have been identified as the main obstacles of the investment growth in Indonesia. These problems are made productivity and accumulation of capital is low, making the improvement of the economy sluggish.

Reflecting this was the deteriorating quality and contribution of capital to economic growth, the low total factor productivity (TFP) and the persistently high incremental capital output ratio (ICOR). Over time, the combination of these factors has led to supply-side rigidity that has constricted responsiveness to policy stimuli. This has reduced the effectiveness of transmitting macroeconomic policy stimulus to the real sector. Instead, stimulus of this kind can easily trigger rapid overheating in the economy.

In order to improve investment performance, government should forefront the efforts to minimize risk in the business sector, such as improvement in investment climate and renewed development of infrastructure. In addition, the micro risks problem such as corruption, bureaucratic red tape, licensing procedures, manpower regulations, the high cost economy and market distortions are also has to be vanished in order to ensure the improvement of investment climate in Indonesia. These strategies continually will create a good perception of bank and private sectors to fulfill new loan and investment.

There are, at least, 3 important policies regarding to solve investment problems. The first is the policy based on institutional reforms. The second is the policy based on infrastructure development. The third is the policy based on financial restructuring.

For institutional reform, the policy is expected to answer perceptions of uncertainty in the investment climate in Indonesia. Furthermore, this policy has to cover the general improvements in investment services and harmonization of central government and regional government regulations. For the latter objective, it concerns to reforms in customs administration, taxation and industrial relations and support for small and medium enterprises and cooperatives.

Lastly, for restructuring financial system government needs to enhance intermediary function of banking system. An increased banking role in financing support is also a crucial point in the achievement of higher levels of better quality economic growth. Banks are expected to shift their financing structure away from consumer financing and money market placements and towards more productive uses, such as working capital and investment financing with priority for labor intensive business activities. Banks will also need to demonstrate greater capacity for seeking new financing opportunities and to be better acquainted with the characteristics of the business community.

3.2. Export competitiveness and Foreign Direct Investment (FDI) policy

Future of support from the export sector will be strongly determined by the ability to promote manufacturing exports, which at this time are still hampered by micro structural hurdles that undermine competitiveness and the ability to seize advantage in the highly competitive global trading environment. Similarly, more intensive efforts are needed to build external resilience by attracting higher volume of longer-term capital inflows for *Foreign Direct Investment (FDI)*, rather than fluctuation-prone portfolio capital flows. Under these conditions, higher economic growth can only be achieved with support from significant expansion in domestic demand compared to the previous year.

3.3. Macroeconomic policy

Several policies concerning various fields including monetary, banking and the payment system has to be synchronized with the general policy direction. Monetary policy has to consistent with efforts to achieve and maintain the government-set inflation target. Banking policy has to foster the role of banks as intermediation institutions without neglecting prudential principles and continuing to reinforce banking institutions. Meanwhile, payment system policy has to be designed to support the effectiveness of policies taken in the banking and monetary

sectors by providing a secure, efficient and reliable payment system. There are, at least two general important strategies for enhancing effectiveness of macroeconomic policy.

First, commitment and policy consistency are crucial elements of raising macroeconomic policy credibility. Indonesia's open economy is highly susceptible to global economic developments. Consequently, Indonesia's economy must have the ability to mitigate the various sources of instability. Furthermore, more coordination between monetary policy and fiscal policy is also needed to enhance the credibility of macroeconomic policy. Better credibility, in turn, reinforces macroeconomic resilience in harmony with restored public confidence in macro policy management. Holistically, macroeconomic policy consistency can lead to lower inflation and a relatively stable exchange rate.

Second, the function and strategy of clear and sound policy communication and dissemination have become pivotal elements to influence the perceptions of economic players towards overall economic prospects. For example, policy to raise fuel prices will develop negative expectation of a prospective economy because the increase of oil price will higher cost of production. This condition consequently will reduce income and investment in the short run. Regarding to this negative consequences, government should has a strategy to communicate with the public to restore confidence that the tight-biased monetary policy was part of an effort to turn economic conditions around.

4. Conclusion

Indonesian economy has shown a gradual improvement since 2000. Despite the growing of GDP over the last 6 six years, investment and export sector still stagnant making the issue of enhancing better quality growth as the key of success. Thus, government needs to be more serious to implement various policies for improvement of the investment climate with the support of stable macroeconomic conditions.

In the banking sector, central bank of Indonesia needs to solve an underperforming intermediation function of banking sector. The role of banking sector is so important to support performance of real sector. In addition, to ensure the effectiveness of macroeconomic policy, there are, at least two important strategies that need to be resolved. First, commitment and policy consistency are crucial elements of raising macroeconomic policy credibility. Second, the function and strategy of clear and sound policy communication and dissemination have become pivotal elements to influence the perceptions of economic players towards overall economic prospects.